



**DEPARTMENT OF THE ARMY
HEADQUARTERS UNITED STATES ARMY FORCES COMMAND
1777 HARDEE AVENUE SW
FORT McPHERSON, GEORGIA 30330-1062**

REPLY TO
ATTENTION OF

AFLG-PR

13 May 2002

MEMORANDUM FOR SEE DISTRIBUTION

SUBJECT: Contracting Information Letter 02-15, Performance-Based Payments (PBPs)

1. References:

- a. 10 U.S.C. 2307(b), Performance-Based Payments, 2 January 2002.**
- b. Federal Acquisition Regulation (FAR) Part 32.1001, subject: Performance-Based Payments.**
- c. Memorandum from the Under Secretary of Defense, Acquisition Technology, and Logistics, 13 November 2000, Performance-Based Payments, enclosure 1.**

2. Reference 1a above provides the authority to make PBPs to contractors. It states in part, "Whenever practicable, payments under subsection (a) shall be made on any of the following bases:

- a. Performance measured by objective, quantifiable methods such as delivery of acceptable items, work measurement, or statistical process controls.**
- b. Accomplishment of events defined in the program management plan.**
- c. Other quantifiable measures of results."**

3. Reference 1b implements the statutory authority and states in part, "PBPs are the preferred Government financing method when the contracting officer finds them practical, and the contractor agrees to their use." In accordance with reference 1b above, PBPs shall be used only if the following conditions are met:

- a. The contract is a definitized fixed-price type contract; and**
- b. The contract does not provide for other methods of contract financing, except that advance payments in accordance with Subpart 32.4, or guaranteed loans in accordance with Subpart 32.3 may be used.**
- c. The contracting officer may agree to exceptions to use PBPs when supported by a sound business case justification.**

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4. PBP is a new financing tool that strengthens the government industry relationship and furthers DoDs commitment to revolutionize its business affairs. It is defined as a method of financing contracts based on the achievement of specific events or accomplishments that are defined and valued in advance by the parties to the contract. PBPs are not tied to or based upon incurred cost of performance. The advantages and disadvantages of PBPs and the strategies for success are at enclosures 2 and 3, respectively.

5. Reference 1c requires that by the end of fiscal year 2002, each MACOM, ensures PBP is the primary form of contract financing in at least 25 percent of contracts valued at \$2 million or more. By fiscal year 2005, this method of financing should be the most prevalent form used in fixed price contracts, such as those for complex services or for production efforts. Our strategy to meet this requirement is as follows:

a. Ensure that all core-contracting workforce successfully completes the DAU Course, "Understanding and Utilizing Performance Based Payments" offered at the DAU Learning Center at <http://clc.dau.mil> by 30 June 2002. The course takes approximately three hours to complete and is worth three Continuous Learning Points (CLPs). The self-paced course is comprised of three lessons that present the implementation of Performance Based Payments (PBPs) as a method of financing fixed-priced contracts following FAR. The course is based on the Department of Defense (DoD) Performance Based Payments Guidebook entitled, User's Guide to Performance Based Payments located at <http://www.acq.osd.mil>. To access the course, login to the DAU Continuous Learning Center at <http://clc.dau.mil>, click on "Learning Center," select "Course Information & Access," then type in "Performance Based Payments." For additional assistance or questions, feel free to contact the DAU CLC administrator at daucleteam@meridianksi.com.

b. PBPs will soon become a critical area for review during PARC review of solicitations.

c. Effective 15 October 2002, provide the following information to the PARC regarding solicitations issued on or after 1 August 2002 with a dollar value greater than \$2M: Number of contracts awarded greater than \$2M and number of contracts awarded greater than \$2M that incorporated PBPs.

6. Services continue to be a significant component of what the Army buys. Therefore, we must continue to implement acquisition initiatives to ensure that we incorporate the best business practices as we continue to pursue and acquire services effectively and efficiently.

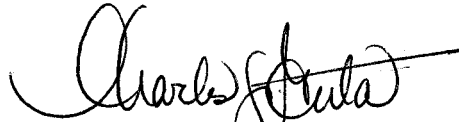
7. You may find additional information regarding PBPs at <http://www.acq.osd.mil> and click on "Acquisition Guidebooks."

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8. Direct all questions and comments to Julie Grace, DSN 367-5690 or email at gracej@forscom.army.mil

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A handwritten signature in black ink, appearing to read "Charles J. Guta", with a long horizontal stroke extending to the right.

CHARLES J. GUTA

Colonel, AC

Chief, Contracting Division, G4

Principal Assistant Responsible

for Contracting



ACQUISITION AND
TECHNOLOGY

THE UNDER SECRETARY OF DEFENSE

3010 DEFENSE PENTAGON
WASHINGTON, DC 20301-3010

NOV 13 2000

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS COMPONENT ACQUISITION EXECUTIVES DIRECTORS, DEFENSE AGENCIES

SUBJECT: Use of Performance-Based Payments (PBP)

The Department has had the authority to make performance-based payments to contractors under sole source fixed-price contracts for several years, but with the exception of their significant use with "other transactions," this financing technique has not been used widely. Recently, the Federal Acquisition Regulation was changed to remove the prohibition on using PBPs on research and development and competitively negotiated acquisitions, and to permit prime contractors with cost type contracts to use PBPs on fixed-price subcontracts (FAC 97-16).

There are many significant advantages to be gained from the use of PBPs instead of cost-based progress payments. The Department must take maximum advantage of the benefits of performance-based payments as the preferred means of providing contract financing under fixed-price contracts by making this form of payment the primary and most commonly used form of contract financing. For fiscal year 2002, we must ensure PBP is the primary form of contract financing in at least 25% of contracts valued at \$2 million or more. By fiscal year 2005, this method of financing should be the most prevalent form used in fixed-price contracts, such as those for complex services or for production efforts.

In fiscal year 1999, there were 195 contract actions valued at \$5.6B that used this form of contract financing. By fiscal year 2005, this method of financing should be used in most contracts that provide financing. Exceptions to the use of this contract financing technique should only be agreed to by the contracting officer when supported by a sound business case justification. The attached summarizes PBP policy and lessons learned.

As with many of the acquisition reforms that we are pursuing, changing the predominant way we provide financing payments under fixed price contracts will require all of us to become more sophisticated customers. To that end, I have directed the Deputy Under Secretary of Defense for Acquisition Reform to lead the development and distribution of a guidance document that will assist contracting officers and program managers in the selection and valuation of meaningful technical progress indicators to use in conjunction with performance-based financing payments. I look forward to your enthusiastic and effective implementation of the actions necessary to successfully transition our contract financing practices to this new paradigm.

J. S. Gansler



PERFORMANCE BASED PAYMENTS (PBP)

Advantages of Using PBP

Using PBP as the principal method of furnishing contract financing under fixed-price contracts has many potential benefits for both the Government and contractors. Among them are the following:

Enhanced Technical and Schedule Focus.

PBP focuses attention on the accomplishment of meaningful and measurable technical progress and on meeting program schedule commitments. By contrast, cost-based progress payments reward incurring cost with only a tangential relationship between those costs and actual, demonstrable progress and schedule results. By linking a contractor's financing payment to critical aspects of technical and schedule performance prior to contract award, PBP reinforces the primacy of technical and schedule connectivity for successful performance. To be successful, parties need to negotiate, at the time of contract formation, the events or accomplishments to be measured, how those measurements will be made, and what value these events or accomplishments will have for financing payment purposes. Thus, both parties will have, in effect, converted appropriate portions of the program plan and schedule into meaningful criteria that will be used throughout the life of the contract to make financing payments. Financing payments will occur only when meaningful, objectively determinable performance accomplishments are achieved.

Broadened Contractor Participation.

Traditional cost-based progress payments can only be used with those contractors that have approved accounting systems. This practice may unintentionally reduce the array of potential contractors with whom the Department can do business. When PBPs are used, however, the contractor's accounting system is no longer a precondition of the financial relationship between the parties. Many of today's leading technology firms do not regularly perform under Government contracts and, therefore, have no need for government-compliant accounting systems. Use of PBP allows the Department to eliminate one potential barrier to wider supplier participation in the Defense marketplace.

Reduced Cost of Administration and Streamlined Oversight.

Reductions in the oversight and compliance costs of both the Government and contractors are feasible when using PBP. Because the accounting system is not an integral part of the contract financing process, the Government does not require auditors to review payment requests for accounting consistency and compliance with oversight systems, such as cost principles and material management accounting systems. Similarly, contractors' financing requests are event or accomplishment driven and contain no financial information that must be prepared according to financial regulations and practices dictated by the Government. Both parties should be able to reduce non-value-added cost-based oversight.

Enhanced and Reinforced Roles of Program Managers and IPTs.

PBP is a management tool that allows the program manager to link financing to performance in fixed-price contracts because the contractor is entitled to agreed-upon payments only when specific measurable events have been accomplished. The IPT, composed of government program management, contracting officer, technical and logistic managers, Defense Contract Management Agency (DCMA) and the respective contractor team members jointly develops the PBP plan.

The program manager, supported by IPT members, gives the "thumbs up or down" regarding the assessment of the contractor's technical and schedule results. "Thumbs-up," the program manager verifies to the contracting officer that the contractor is meeting the event requirement and is entitled to payment in accordance with the jointly agreed-to performance schedule. "Thumbs-down," the contractor does not receive payment for that event. The Government's business and technical managers are directly involved in all aspects of the process.

PBP is in effect "self policing" because the contractor is entitled to the agreed-upon payments *only when* it accomplishes the paying event and the program manager confirms it before the disbursement is made.

Competition Considerations.

In a competition where the solicitation invites offerors to propose PBPs, the contracting officer should ensure that each offeror's PBPs comply with FAR 32.1004 and are reasonable and consistent with other technical and cost information in the offeror's proposal. If the contracting officer anticipates that the cost of providing PBPs will have a significant impact on the selection of the best-value offer, the solicitation should provide for the adjustment of proposed prices to reflect the estimated cost to the Government of providing each offeror's proposed PBPs.

Cash-Flow Advantages.

Structuring effective performance-based events or accomplishments can provide significant cash-flow advantages to a successfully performing contractor. PBPs can, under current FAR provisions, be made for up to 90 percent of the contract or line item's price, whereas cost-based progress payments are currently limited to a fixed percentage of incurred costs (currently 75 percent). This can be advantageous from a cash flow perspective. For instance, assume a fixed-price contract for \$10.0 million that has a potential profit of 15 percent as negotiated and one deliverable item. Under PBPs, the total amount financed could be as much as \$9.0 million. Using the current progress payment limit of 75 percent, traditional cost-based progress payments could amount to slightly more than \$6.5 million. The difference in cash flow over the life of the contract is \$2.5 million, or a 38 percent improvement with PBPs over traditional progress payments. Conversely, if significant technical or schedule accomplishments are not being achieved as originally contemplated, the contractor's cash flow picture can be markedly disadvantaged under PBPs versus traditional progress payments. However, this is another reason why the Government

should prefer to use PBPs as another means to motivate good performance by its contractors and realistic technical and schedule plans by both parties.

Importance of Realistic Performance Milestones.

While it is important to ensure that performance-based payment triggering events be carefully chosen to reflect meaningful contract progress, it is important to keep in mind that the events are being selected to make financing payments. To this end, acquisition personnel should consider that, during the early stages of a project, the contractor's rate of expenditure might be high. Therefore, selection of meaningful payment milestones and values during the early phases of a contract is necessary to ensure that the contractor's cash flow needs are adequately addressed. Experience has shown that early performance-based payments are important to motivate contractor effort and assist in meeting the cash flow needs that typically arise during the early stages of performance. However, contracting officers should also ensure that PBPs not be structured to result in payments that are in excess of the expected value of performance events, and that they not be designed to result in an unreasonably low level of contractor investment in the contract.

Are There Any Drawbacks?

Effective planning is key to success, and decisions and agreements must be reached during the contract formation phase. The parties have to identify and agree upon which events or accomplishments will be used as a basis for contract financing payments, how they will be measured or confirmed, and the values of the events. In reality, however, all programs have projected technical plans and schedules when the contract is being negotiated so the parties could agree upon milestones that will become the basis for PBPs. Setting valuations for the events selected is a unique requirement under a PBP approach. However, even this added activity has a beneficial impact in clearly setting technical and schedule success as the key contract goals. It is important to remember that PBP is a financing tool that is available only for use under fixed-price contracts, so the degree of uncertainty for price and schedule commitments should be low. In order to use PBPs effectively, guidance and focused training on the selection and valuation of meaningful payment events is critical. This guide is available for the acquisition workforce on the Acquisition Reform Web page (www.acq.osd.mil). A distance-learning module is also under development and will be reviewed with the Services prior to release to the workforce.

Performance-Based Payments (PBPs) — Strategies for Success

- 1. PBP is a benefit to both the government and industry, but careful planning is essential.**
- 2. PBP is the preferred financing technique for fixed-price contracts.**
- 3. Early joint government/industry Integrated Program Team (IPT) involvement will enhance program success.**
- 4. Collaborative teaming between the contractor and the Government leads to a clear understanding of key program events.**
- 5. PBP is a financing solution, not partial or final acceptance and enhances the government's decision-making responsibility through early agreement on program milestones.**
- 6. Generally stable programs are the best candidates for PBPs.**
- 7. Successful PBP focuses on measurable technical and schedule performance fostering a detailed understanding of the integration required for successful program execution.**
- 8. Frequent program/payment events are preferred, generating stable contractor cash flow and successful programs.**
- 9. Events should be established with built-in flexibility that allows for payment to proceed if only a small percentage of the work remains to be accomplished.**
- 10. Using a standard format for processing PBPs will speed Defense Contracts Management Agency (DCMA) event validation and Defense Finance and Accounting Service (DFAS) payment processing.**